

AGENDA PAPER

IFRS Foundation Trustees meeting—Due Process Oversight Committee

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Feedback on Leases Due Process

Introduction

1. This paper reviews how the IASB has responded to feedback received on its 2013 Exposure Draft *Leases*. This review has been prepared in response to concerns raised by stakeholders.
2. Although the IASB and the FASB agreed on key aspects of accounting for leases in their redeliberations in March 2014 (in particular, with respect to recognition of leases on the balance sheet), a converged solution has not been reached for the recognition of and presentation of lease expenses in a lessee's income statement. Following this there has been growing debate and interest in the project. In particular the project was mentioned by the Financial Reporting Council's (FRC) Chairman, Win Bischoff, in his presentation to the IFRS Foundation Trustees at the Trustee meeting in July 2014.
3. The FRC raised concerns that stakeholder views are not always given due weight and technical purism and an anti-avoidance/compliance-driven mindset prevails—it considered the leasing project to be an example of where this is the case. Although the FRC acknowledged that the IASB has taken steps to improve communication with stakeholders, it noted that there are still some areas that require attention. In particular the FRC suggested that stakeholders need a better understanding of why their views/suggestions are not taken up by the IASB.
4. It is noted that no formal complaint regarding the due process of the leasing project has been received.

Review of Leases Due Process

5. The objective of the Leases project is to develop a new Leases Standard that establishes the principles that lessees and lessors should apply to report useful

information to investors and analysts about the amount, timing and uncertainty of cash flows arising from a lease.

6. The project is conducted jointly with the Financial Accounting Standards Board (FASB).
7. In May 2013 the IASB and the FASB published a revised Exposure Draft that set out a new approach to lease accounting, taking into consideration feedback received on the Discussion Paper *Leases: Preliminary Views* published in March 2009 and the initial Exposure Draft *Leases* published by the IASB and FASB in August 2010.
8. The comment period for the Exposure Draft closed on 13 September 2013; 640 comment letters were received. In addition, during the comment period extensive outreach activities were undertaken. Specific focus was placed on obtaining feedback from the investor community, which often cannot be obtained through comment letters or other public forums. The outreach activities included:
 - a) meetings with around 270 investors and analysts throughout the world;
 - b) individual fieldwork meetings with more than 25 preparers to discuss, in detail, the cost of applying the proposals; and
 - c) public round tables held in Europe, the US, Latin America and Asia.
9. In view of this extensive feedback particular care was taken by the IASB to plan how to consider and evaluate the feedback received. The IASB decided that before making any tentative decisions it would spend an extended period of time evaluating the comment letters and other feedback received, and discussing with its advisory bodies alternative ways to proceed.
10. In November 2013 at a joint meeting of the IASB and the FASB (IASB Agenda Paper 3A for that meeting), a summary of the comment letters and outreach activities (including outreach undertaken with investors and analysts) was presented at a non-decision-making board meeting. In January 2014, the boards also discussed alternatives on how to proceed on lessee and lessor accounting at a non-decision-making board meeting.
11. In February and March 2014 in public meetings, the project team consulted the IASB's main advisory bodies—the Advisory Council, the Capital Markets Advisory Committee (CMAC), the Accounting Standards Advisory Forum (ASAF) and the Global Preparers Forum (GPF). This included the project team reporting their findings from the feedback and discussing the alternatives on how to proceed. The

feedback received from the advisory bodies was summarised and presented to the IASB in an education session and thus was available to the IASB before voting on the relevant decisions (Addendum to agenda paper 3I March 2014¹).

12. It was not until March 2014 that the IASB took the first tentative decisions on important aspects of the project. In delaying any tentative decision until March 2014, almost six months after the close of the comment period, the IASB was able to base its tentative decisions on the feedback received on the 2013 ED and the advice received during February and March 2014 from its advisory bodies.²
13. The IASB has reported regularly, as part of the Technical Updates report, to the DPOC on the due process steps taken:
 - a) January 2014: it was noted that extensive outreach activities had been undertaken during the comment period, focusing in particular on obtaining feedback from investors and analysts and on understanding the drivers of costs for preparers.
 - b) April 2014: an overview was provided of the outreach undertaken during the comment period and the additional work undertaken in preparation for the March 2014 meeting, at which the IASB and FASB took a number of important decisions. This section of the report is reproduced in the Appendix to this paper.
 - c) July 2014: an update on the IASB's tentative decisions was provided. It was further noted that the ASAF had received an update on the project at its meeting in June 2014. At the ASAF meeting, the IASB and FASB members present indicated that the boards would continue redeliberations on a joint basis, with the objective of minimising any differences between US GAAP and IFRS.

¹ IASB paper [Addendum to Agenda paper 3I](#)

² The tentative decisions of the IASB in relation to the treatment of leases in a lessee's income statement are consistent with the recommendations of most members of the CMAC and the ASAF, and the factors considered in reaching those decisions were consistent with the strategic advice obtained from the Advisory Council. The views of the members of GPF were mixed.

Current status

14. The accounting for leases has historically been a controversial topic. A report by the US SEC (2005)³ noted:

It is likely that a project on lease accounting would generate significant controversy...a project on lease accounting is likely to take a significant amount of time as well as...resources. Nonetheless...the potential benefits in terms of increased transparency of financial reporting would be substantial enough to justify the time and effort required.

15. The project is proposing a significant change to financial reporting, which will result in material assets and liabilities being added to many entities' balance sheets. It is therefore not surprising that the project has met with strong resistance and this resistance is increasing as the project moves closer to completion.
16. As noted, the IASB and the FASB have reached tentative decisions on many important aspects of the project and those decisions are substantially converged—the boards agree that leases should be recognised on a lessee's balance sheet, and agree on the definition of a lease, on the measurement of lease liabilities and that in essence lessor accounting should remain unchanged. Nonetheless, it appears that resistance to the project has been exacerbated following the IASB's and FASB's tentative decisions in March 2014, when the boards did not agree on how a lessee would recognise and present lease expenses in its income statement. It might be argued the lack of full convergence provided fuel for further debate on the accounting for leases.
17. In June 2014 EFRAG and the some European National Standard Setters (French, German, Italian and UK) launched an additional public consultation on lessee accounting. The EFRAG website says:

On 16 May 2013, the IASB issued the revised Exposure Draft Leases (the ED). After the comment period ended in September 2013, the IASB and the FASB (the Boards) started the re-deliberation process. In March 2014, the two Boards tentatively decided to support two different approaches for lessees. The IASB proposed a single model based on Type-A lease accounting. The FASB proposed a model that, based on IAS 17 criteria, distinguishes leases that are in effect purchases and other leases; these are accounted for using a straight line

³ Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

cost recognition pattern. EFRAG and the National Standard Setters are performing this additional public consultation to acquire constituents' views on the two alternative approaches for lessees. EFRAG and the National Standard Setters are also interested in examples of contracts or transactions that would qualify as leases under the proposals, but in constituents' view are in substance services.

What is the objective of this additional public consultation?

The objective of this additional public consultation is twofold. Firstly, it is meant to help to identify transactions that would qualify as leases under the proposals but constituents view as in-substance service transactions that should not be recognised by a lessee. Secondly, we seek constituents' views and their preference of the two alternative approaches proposed by the Boards.

18. In addition, in July 2014 EFRAG launched an additional public consultation for users of financial statements. The EFRAG website notes:

The objective of this additional public consultation is twofold. Firstly, we seek users' views and their preference of the two alternative approaches for lessees re-deliberated by the Boards. Secondly, it is meant to help to identify transactions that would qualify as leases under the proposals but, in opinion of users of financial statements, should be excluded from the scope of the expected requirements for leases and treated as in-substance service transactions.

19. In advance of EFRAG launching its consultations, IASB and EFRAG staff have had open and constructive discussions—particularly in relation to identifying transactions that would qualify as leases (ie the definition of a lease). The EFRAG Technical Experts Group have discussed this matter several times over the past few years in an attempt to develop an alternative approach for the IASB, or suggestions to improve the proposed definition of a lease, most recently in April 2014. Despite its discussions, EFRAG TEG has been unable to formalise advice to the IASB on the definition of a lease.
20. The definition of a lease will be discussed at the ASAF meeting in September 2014. The discussion will be based on an EFRAG staff paper that has not been reviewed

or endorsed by EFRAG's Technical Experts Group (TEG). We recognise the importance of the discussion to be held at the ASAF meeting.

Actions by the IASB

General concerns

21. As for all of the IASB's projects, the IASB website provides a page providing information for interested parties. In addition to information about the early stages of the project (such as the first Exposure Draft), the IASB Leases project page provides links to the following information:
 - Comment letters on 2013 ED
 - Comment letter summary (2013 ED)
 - Comment letters received outside the comment letter period
 - Lessee accounting—summary of investor outreach May-September 2013
 - Links to the IASB papers and IASB Update
 - Feedback received from the IASB Advisory Bodies.
22. This information is provided as part of the project. The IASB papers set out the feedback received and makes recommendations based on that feedback.
23. In addition to the information listed above, the project page also includes information that we have published more recently, in August 2014. This information has been provided to help stakeholders to understand the IASB's tentative decisions in the redeliberations to date. This information seeks to explain, in a concise and understandable format, the reasons that the IASB has made particular decisions and not pursued other alternatives that have been suggested. It is also hoped that by providing a summary while redeliberations are continuing, interested parties still have the opportunity, if relevant information has not been considered or is considered to have been given inadequate emphasis, to bring this to the IASB's attention before finalisation of the decision-making process. The additional information provided includes:
 - a) A Project Update (a copy of the Update is at Agenda Paper 3C(i)). The Update set out the most important tentative decisions reached in the Leases project this year and explains the basis for those decisions, including how the

IASB considered the feedback received. The Project Update was sent to members of the IASB's advisory bodies.

The Project Update explains the basis for the IASB's tentative decisions on the income statement treatment of the lessee model (ie the current area of difference with the FASB), as follows:

Information for investors and analysts: link between the balance sheet and the income statement

On the basis of feedback received, the IASB concluded that a model that separately presents interest and amortisation for all leases recognised on the balance sheet would provide information that is useful to the broadest range of investors and analysts. This is because most investors and analysts consulted think that leases create assets and debt-like liabilities for a lessee. The model is easy to understand—a lessee recognises fixed assets and financial liabilities, and corresponding amounts of amortisation and interest. It also avoids any structuring that might arise from having different accounting for different leases, which was a concern expressed by some investors and analysts.

Conceptual considerations: all leases provide a right of use

The IASB is of the view that all leases result in a lessee obtaining the right to use an asset and the provision of financing, regardless of the nature or remaining life of the underlying asset. Accordingly, the IASB concluded that all leases should be accounted for in the same way.

Some feedback received on the 2013 ED indicated that it would be difficult to understand why for some leases there would be (a) no amortisation or depreciation of the lease asset recognised on the balance sheet and (b) no interest on the lease liability (a financial liability) recognised on the balance sheet. Some questioned this accounting because a lessee would measure the lease asset as a balancing figure.

Operational cost and complexity: single model

On the basis of feedback received, the IASB think that the cost of accounting for leases under both models is broadly similar. This is because the most significant costs for lessees arise from recognising leases on the balance sheet—the difference between the IASB's and the FASB's lessee model does not result in any difference in the measurement of lease liabilities.

However, the IASB's model would no longer require a lessee to classify leases and, thus, reduces complexity.

In addition, it would always result in a lessee amortising the lease asset in the same way as other fixed assets. Consequently, a lessee could use existing fixed asset information systems to account for all lease assets.

- b) A podcast and supporting presentation.
24. We have also continued to hold meeting with key stakeholders to discuss and review the IASB's tentative decisions. Since March 2014 we have met a number of preparer industry bodies, had discussions with various individual preparers and investors on specific topics, and discussed possible disclosure requirements with the CMAC and the GPF.

FRC concerns

25. To gain a more in-depth understanding of the FRC concerns raised at the July trustee meeting, Sue Lloyd and Patrina Buchanan met with Melanie McLaren and her staff. From our perspective the meeting was very constructive and the FRC raised helpful suggestions regarding ways in which we could improve communication.
26. Subsequent to this meeting the FRC has outlined that it is particularly concerned that the feedback that it provided to the IASB in response to a discussion at the ASAF does not seem to have been taken into consideration (for example, their suggestions regarding the definition of a lease were not reflected in board papers) and that the FRC has not been provided with any explanation for this. The FRC has suggested that due process should address activities of the IASB that go beyond the agreed minimum set out in the *Due Process Handbook* and the exercise of judgement in bringing matters to the Board. At the meeting the FRC explained it felt that there was no clarity about why suggestions that it had made had not been pursued (in a sense we had failed to 'close the loop' with them). We explained that board members and staff did consider the FRC's suggestion regarding the definition of a lease, but there was no appetite for the suggestion. Consequently it was not included in the board paper. We note that the FRC's suggestion, to treat lease contracts that contain substantial services as services (and, consequently, to exclude them entirely from the leases standard), is different from existing IFRS. *IFRIC 4 Determining whether an Arrangement contains a Lease* requires an assessment of whether arrangements are, or contain, a lease. If an arrangement contains a lease, then an entity is required to apply IAS 17 *Leases* to the lease portion of the arrangement. We also note that current UK Financial Reporting Standards are consistent with IFRS.
27. Following this meeting we have sought to address the specific issues raised. For example, in the Project Update posted on the website we included a discussion of

why the suggestions regarding the definition of a lease were not pursued. We have posted the letter that the FRC sent to us in March 2014 on our website following their confirmation that they were happy for this to occur and (as noted above) the definition of a lease is due to be discussed at the ASAF meeting in September 2014.

Next Steps

28. The IASB will continue to deliberate the comments received to the 2013 ED jointly with the FASB and aims to finalise the deliberations in 2014. As previously noted the project will also be discussed at the ASAF meeting in September 2014.

Conclusion

29. The staff are of the view that the due process requirements have been fully adhered to and have been applied in an appropriate manner for such an important and controversial project. The redeliberation process has been carefully planned and executed in a manner that allows time for full consideration of the feedback provided and with opportunities for key stakeholders (including the IASB's advisory bodies) to provide further advice and input during redeliberations after the comment period.
30. However, the feedback we have received highlights that we can still improve communication. It also reinforces the importance of making additional efforts to communicate the basis for decisions in an accessible way and to ensure that there is an understanding of the basis for decisions—particularly where there are differences in decisions on a joint project. We think that the concerns highlighted in this project have recently been exacerbated by introducing the convergence discussion into the debate.

Appendix

Extract from Technical Activities Update Report to the Due Process Oversight Committee – April 2014

Leases

21. The objective of the Leases project is to improve the quality and comparability of financial reporting by providing greater transparency about an entity's leverage, the assets it uses in its operations and the risks to which it is exposed from entering into lease transactions.
22. This is a joint project with the FASB. In May 2013, the boards published a joint and revised Exposure Draft on Leases, which was open for comment until 13 September 2013. Under the proposals, a lessee would report assets and liabilities for all leases of more than 12 months on its balance sheet. The recognition of lease-related expenses in the lessee's income statement for most real estate leases would be different from that for most other leases, to better reflect the differing economics of those leases. The ED also proposes some changes to the accounting applied by many equipment and vehicle lessors, which would better reflect how such lessors price their leases.
23. Extensive outreach activities were undertaken during the comment period, focusing in particular on obtaining feedback from users of the financial statements and on understanding the drivers of costs for preparers. A concentrated effort was made to reach users of financial statements—over 35 meetings have been held, involving more than 220 investors and analysts from Europe, North America, Africa, Asia and Australasia⁴. In addition, a series of public round tables took place.
24. As expected there was a very high response rate to the ED: we received 640 comment letters. A summary of the comment letters and outreach activities (including with users of financial statements) was presented at a joint Board meeting in November 2013. While there is praise for the boards' efforts to respond to concerns regarding the 2010 ED, there is nevertheless considerable concern about the cost and complexity of the 2013 ED proposals. The boards started to redeliberate the lessee model, the lessor model and possible scope simplifications in January 2014, with the aim of reaching decisions on those central topics in March 2014.
25. In preparation for the March 2014 meeting, the IASB also had substantive discussions on the leases project with all of its advisory bodies in February and March 2014:
 - Advisory Council—the IASB sought advice on the strategy for the project. The Advisory Council members were supportive of the project overall, encouraging the IASB to move forward and finalise the project on a timely basis.
 - Accounting Standards Advisory Forum—the IASB sought the views of ASAF members on all of the key technical issues on the project, including the lessee and lessor accounting models.

⁴ A summary of the outreach is available on the Leases project page of the IASB website at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/Lessee-accounting-investor-outreach-summary-May-to-September-2013.pdf>.

- Capital Markets Advisory Committee (CMAC)—the IASB sought the views of CMAC members on which of the possible ways forward for lessee accounting would provide the most useful information for investors and analysts.
 - Global Preparers Forum (GPF)—the IASB sought the views of GPF members on the possible ways that the boards could reduce the costs and complexity of the proposals in the 2013 ED.
26. At their March 2014 joint meeting in Norwalk, the IASB and the FASB reached tentative decisions on the lessee accounting model, the lessor accounting model, scope simplifications for ‘small-ticket’ leases and the determination of the lease term:
- Both boards tentatively decided to require lessees to recognise assets and liabilities for all leases (other than short-term leases and, for the IASB, leases of small assets such as laptops and office furniture). The boards came to different conclusions, however, on the recognition and presentation of lease expenses in a lessee’s income statement:
 - The IASB decided upon a single lessee model, whereby a lessee would recognise interest on lease liabilities separately from amortisation of lease assets.
 - The FASB decided upon a dual lessee model that would retain the existing distinction between operating and finance leases. This would, in essence, result in no change to the lessee’s income statement compared with the income statement outcomes under existing requirements.
 - Both boards decided to retain existing lessor accounting. Because existing IFRS lessor accounting is slightly different from existing US GAAP lessor accounting, the boards reached slightly different conclusions, which are not expected to result in any significant differences in practice.
 - The boards reached converged decisions on the lease term and short-term leases.
27. The boards agreed that the project will continue on a joint basis. It is currently expected that the IASB will continue to redeliberate the proposals in the 2013 ED, together with the FASB, until later in 2014. It is therefore expected that a life-cycle review of the due process procedure will take place in the first quarter of 2015.